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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

October 11, 1994

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 94-1, Price Cap Performance Review for Local Exchange Carriers*

Yesterday, Chairman of Pacific Telesis Group Phil Quigley made the following speech at the U.S.T.A. Convention in San Diego, California, which was attended by FCC commissioners and employees. In it, he briefly discussed Price Caps issues. Please associate this material with the above-referenced proceeding.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Alan F. Ciamporcero

Attachment

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List ABCDE

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Remarks by Phil Quigley

Chairman and CEO, Pacific Telesis

97th Annual Convention

United States Telephone Association

San Diego, California
October 10, 1994

Contradictions on the Infobahn

Good morning and welcome to San Diego.

I wonder if anyone knows just how much effort went into this meeting. Gary McBee sold his house and moved here so he could personally supervise the thing.

No kidding. A new house just a few miles from here. We're all going over later.

Just turn left out of the parking lot and go west to Horizon Lane. At the top of Horizon you'll see a big mansion on a hill overlooking the Pacific. Well -- that's not it. From there you go down the hill to Gary's trailer park -- Lot 7 -- big Winnabago.

Look for the bumpersticker that says: "Helmet Laws Are For Wimps."

My hat's off to Gary McBee. In one year, he's reasserted USTA's influence in this country -- and that's no joke.

The big score, of course, was bringing Roy Neel in to head our team.

Now I know how they felt in Kansas City when Joe Montana came to town. In just a year, the return on our investment in USTA has risen, thanks to Gary, Roy and his team.

A few weeks ago, I was thinking about this morning's session. I had a stack of newspaper clippings in front of me. They all said Congress was putting the final touches on the first major revamping of telecommunications law in 60 years.

It looked like a 50/50 chance the bill would pass before Congress adjourned -- and what a good topic that would be: Historic progress toward the Communications Superhighway.

OK -- Plan B. Instead of reviewing the re-invention of regulation, I'm going to tell you what I think about the political forces that killed a potential sea-change.

It wasn't the RBOCs that killed it, as some charge. It wasn't Senator Hollings, or Senator Dole. And it definitely wasn't Congressman Dingell.

It was the "system," and those who feed myths into the system, so well disguised that they look to some people like genuine "think tank" facts.

I've thought about what I want to say here, because if I didn't, I might easily slip into ranting and raving, like I saw Ted Turner do recently on C-SPAN.

Ted wants to own a network -- one of the big ones. He says he had a deal a year ago, but his owners stopped him. Then, he says, they turned around and tried to buy the same network. He felt cheated, and he was so angry it was hard to understand what he was talking about.

Well, I'm not happy either. But I want to be understood. So let's not rave, but instead go back to the beginning and explain why I believe each person in this room should also feel cheated.

We were cheated, not just because we didn't get a bill, but because all local exchange carriers were cited as anti-competitive schemers aiming to run others out of business.

Nothing could be further from the truth. The shame is that it worked for those who stooped to it.

We were also cheated because we'd been pretty fired up about this thing they call the Communications Superhighway. And we still are.

Several of us have made major investment commitments -- BILLIONS -- in a good faith expectation that government was serious about clearing away arcane regulatory barriers to modernization.

A year ago, when the hype was hot, we heard bold promises from Washington. It was "time to sweep out the legislative underbrush" and make way for the Superhighway.

Now, the hype has cooled. The congratulatory letters, bearing the great seals of power, have dwindled. And we're left with policy potholes that stretch from the beautiful San Diego harbor to the swamps of the Tidal Basin.

Al Gore has a vision and he's been reasonably successful in capturing the imagination of the public.

There's magic in that vision, but also challenge. It won't be easy to create the right environment for such a vast national undertaking -- one that's variously been estimated in the hundreds of billions by the time it's done.

All of it, private capital.

I don't think I stray into high finance jargon when I say that such an endeavor will require TRUST among the parties.

Without that, who would be foolish enough to risk billions?

And yet, sad to say, trust is lacking so far.

The FCC promulgated a video-dial-tone plan more than a year ago. We followed the rules and submitted plans to participate. So have a dozen others. Just one has been approved.

Under Al Sikes, the Commission had claimed that, with video dial tone, it had come up with the model of the future, and it said it was eager to start rolling.

We applauded that breakthrough as visionary. We want to take it forward, but nobody can move. There's total uncertainty.

The lawyers and some politicians question the efficacy of video dial tone and they've put the FCC in an awkward position.

All parties were banking on legislation to clarify the situation and it didn't happen. So we face more delay.

People seem to forget that we've relied on FCC pronouncements as a basis for billion-dollar vendor contracts. They've forgotten that they control the buildout of the Communications Superhighway.

Well -- as hedges against the belief that we're members of an evil empire, we get micro-regulation, justified by dishonest rhetoric like the "99% bottleneck," and the "800-pound gorilla."

The rhetoric comes from the $100 BILLION Rejectionist Front -- namely, the long distance industry, teamed up with the cable business.

What do they have in common? A desire to stop you. Box you in so you get weaker and weaker over time, until you're only strong enough to take care of less attractive market segments. That will keep you alive, they figure, and -- more important -- keep universal service advocates off their backs.

That, in turn, will leave them free to concentrate on the profitable markets. What a happy ending. For them.

Has anyone ever wondered why the IECs and the Cable companies care so intensely about preserving the lowest possible basic telephone rates?

Are they just naturally passionate about the public interest?

Of course not. They know that, as long as basic rates can be kept way under water, your other rates will have to remain fat -- and highly vulnerable to cream skimming.

These people are not subtle. In the recently deceased Senate legislation, they had the audacity to suggest that a re-seller, without any facilities investment whatsoever, could get all the unbundled pieces from you and THEN get protected as a "carrier of last resort"!

That's a transparent scheme to let sharpies, who had never invested a dime in the national infrastructure, mine wealth out of the investments of others.

Incredibly, some policy makers bought off on it.

The bottom line here is that current telecommunications policy is attempting the impossible. It's attempting to build a superhighway on a road-bed of distrust.

It just won't work. In fact, it will only get worse. There's a recent incident that suggests it already has. I'll get to that in a minute, but first, a few items of news from the convergence front -- the point of which is that we're all sailing into uncharted water, and it's getting rough.

But if you think you can just hunker down until all this blows over, I'd bring that up for re-consideration if I were you. The Information Industry will be fundamentally re-drawn in the next few years, and nobody gets to sit this one out.

The key trend now on the radar screen is consolidation.

Giant cable operators will gobble up the rest. John Malone, as usual, triggered some heart attacks in a speech last month. He said there are about 100 major cable companies today. In a few years there will be 5. His words.

Broadcast television networks seem ripe for acquisition, and the buyers are likely to be Hollywood studios.

The computer business is in a price war to the death.

Margins are paper thin and yet advertising expenditures keep rising.

In the 3 months before Christmas, Apple will air more than 900 spots on MTV alone -- advertising like there's no tomorrow.

And, indeed, the rumor mill last week was questioning whether Apple has a tomorrow .

Meanwhile, channels and content are coming together.

The Tribune Co. recently did a deal with Time Warner to start a 24-hour interactive TV news operation.

The Tribune Company owns the Chicago Tribune, and television stations in several major markets.

It will contribute news gathering capability. Also, its advertising experience -- which becomes home shopping. And its entertainment news background -- which becomes on-line ticket sales.

The Tribune Company also owns the Chicago Cubs, which is not irrelevant. It's a form of content.

The Cubs are a television program. And, if Ken Burns is to be believed, that program is sure to out-live Roseanne.

For its part, Time Warner is installing the distribution channel -- high bandwidth networks in communities around the country.

Cox and Times Mirror recently did a deal that pulled Cox from 6th to 3rd among cable operators, with a $2.2 billion company.

Times Mirror took the cash and bought a couple of multimedia companies.

That makes sense when you consider that Times Mirror owns Field & Stream, Golf Digest, Ski magazine and other publishing properties that can readily be digitized and distributed electronically in vivid multimedia formats. It makes sense!

And don't forget the hype superstar of the year -- the Internet. Sure, there's a lot of hype around it -- but it's building businesses that are anything but imaginary.

For example: When only "techies" used the Internet, it hardly mattered that it was hard to navigate. But now, entrepreneurs are turning that difficulty into opportunity. Last year, Internet gateways scored revenues of $49 million. By the year 2000, the forecast is $2 BILLION.

Another whole new industry -- people who work for Internet hot-lines, answering questions for the bewildered "newbie," as new users are called. These Internet guides make $100 an hour, a lot more than a young corporate lawyer.

Talk about industry revolution -- everybody here is aware of wireless. Bell Atlantic and NYNEX have pooled their cellular assets.

AirTouch, our spun-off cellular company, has done a deal with U.S. West.

The objective in all this wireless maneuvering is seamless service to compete with AT&T -- now that it's acquired McCaw.

The wireless market will grow even faster with PCS, when prices will fall toward the payphone level. The FCC says there will be 60 million wireless users 10 years from now.

What does all this mean? It means there's going to be plenty of competition for low-end business and residence customers from large consolidated companies, and if the local exchange companies are to be unshackled to fight for their lives, policy makers will have to act boldly and soon.

I know it can be done, because we've seen some bold leadership recently in California.

Our state's PUC last month issued a plan that will bring intraLATA competition to California, starting January 1.

It's a fair deal that will lead to free and open markets -- including interLATA -- by 1997.

Meanwhile, our state legislature was passing an interLATA relief bill that put the State of California behind the proposition that all carriers should be able to carry interLATA calls. Governor Wilson signed it a few days ago.

While I'm proud of California's recent record in public policy, I'm still concerned that some state officials remain blind to the destructive effect of our modified price caps plan which has governed us since 1990 and put us under the pressure of an ever-increasing and unattainable productivity factor.

It's killing us. If someone recommends it for your state, fight it with all you've got. It's the most perverse incentive mechanism yet. The faster you run on the productivity growth treadmill, the faster you pump the life out of your business.

We've done productivity miracles in California over the last decade, and for that we've earned $2 billion in rate cuts.

The only feasible way to set this wrong incentive right is Pure Price Caps.

I don't pretend to be the first to surface this issue. And, clearly, I have a vested interest in greater incentives for my shareowners.

But Andrew Barrett had no such motive, when, as a member of the FCC, he said, essentially, what I just said -- that....

......well, let me quote him verbatim, so there's no question:

"The regulator," he said, in a speech to the Florida Economic Club in 1992, "will be increasingly powerless to guarantee either recovery of expenses or a return on investment. There will be less certainty about what the customer will buy and some products will certainly fail. And there will no doubt be competitive alternatives to all of them."

He went on to say: "Once the local exchange carriers are transporting broadband video along with voice services, and wireless is used extensively for local access, the allocation of costs will become a nightmare with little meaning, and pricing distortions will become a reality.....

"Both the industry and the country would be well served," he concluded, "if a modified plan were in place before the local exchange carriers begin to make investments in new areas such

as video and wireless." End quote.

You were right, Commissioner Barrett. Both the industry and the country WOULD have been well served by a bit of foresight. But it didn't happen, and now we're where you warned we might be.

Well, let's shift gears to the bill that just died -- S-1822. What a disappointment.

By the time it neared a vote, the legislation had been completely hijacked by forces who fear open markets -- and anything else new.

Among other things, our opponents used a report commissioned jointly by AT&T and MCI to support the unsupportable -- namely, that local exchange is a captive monopoly market, and nobody has what it takes to compete for it.

How odd. Many of our high end customers are gone and hundreds of millions in revenue have been siphoned off by long distance companies -- something the IEC report claimed could not happen.

Obviously, the report was flawed. So we hired our own consultant to critique it -- Peter Huber.

Peter's a delightful man with a towering intellect, and he doesn't suffer fools gladly.

Neither did he suffer gladly the IEC competition report.

It annoyed him, for example, when the authors calculated the following: If a cable company were to win 10 pct of a LEC's customers, the LEC would be left with 99 per cent Is that a new form of math, or what?

See -- we DO need educational reform.

It annoyed me even more that the report completely ignored all the following alternate access options --

Ñ cellular,
Ñ private microwave,
Ñ cable tv,
Ñ private fiber, and
Ñ private satellite.

Well, of course, if all those weren't there, the problem would be far less grave. But they ARE there. If there were no smog in LA, the air would be quite clean. But there IS smog.

As for the future, the IEC report says CAPs will never be able to compete with the RBOCS.

But there are 46 such companies in 80 cities already, and the business is growing at 100 pct a year.

MCI is a co-sponsor of the report that claims CAPs have no future. It's also investing $20 billion to build one. Odd thing to do, wouldn't you say?

The report also plays down the potential of Cable TV to compete with a LEC. The economics just aren't right, they said.

Oh, really? They've done very well in Great Britain. There cable companies provide telephony to 70 pct of households that subscribe to Cable.

There is more promise than that here in the US -- where Cable penetrates 60 pct of American homes. This was an option the authors chose to IGNORE?

The report also down plays the potential of wireless -- which it says will never compete with a wireline solution.

Then AT&T dropped $17 billion to buy a wireless company.

Which is it, ladies and gentlemen? A loop is a loop, wire or not. You can't have it both ways.

The AT&T/MCI report is nothing but a mish-mash of old economic theories selected to suggest one conclusion.

Other theories would lead to other conclusions.

But why bother with unproven theories of any sort when we have, by now, plenty of real-world experience.

Look at the Sprint corporation. It's a long distance carrier with both cellular and local telephony.

Who has accused it's local exchange properties of anti-competitive bottlenecking? Nobody. The theory is evidently no good.

Or else what happened in the coin phone market could not have happened.

The plain, measurable fact is that Brand X pay phones now hold 60 pct of the competitive market, even though most users are well aware that they cost more than the real thing.

So the theory broke down there, too.

The fact of the matter is this: Their theory has NEVER worked since the advent of equal access.

Never.

The bill would have let Cable companies into our markets immediately, while we would have to wait years to enter theirs.

The Cable companies pushed for that because they say we're a monopoly.

EXCUSE ME????

Every last one of my customers runs into competitive choices each and every day. There is not a cable company in the world
that can make such a statement.

But Senate Bill 1822 took the myth of 99% LEC control seriously. As a consequence, we got a bill that was, in its last days, as unrealistic as the study that informed it.

It becomes a public tragedy when such self-serving fantasy gets cranked into some of the most important national legislation in a long while.

It's unfortunate the bill died. We were seeking compromise up to the last minute, but time ran out. In the end, it's better to start over than to roll over -- at the expense of the shareowners.

Business re-investment in plant and equipment varies all over the map in this country. The average company re-invests about 11 per cent of sales.

Pacific Bell last year re-invested more than 23 pct of sales.

There is, one assumes, a wide-spread agreement on the relationship between investment risk and return. The more risk, the greater the possible return. You can't find anyone who will openly argue with that. It would sound just plain unreasonable.

And yet, as we see more competitive cherry picking -- and I mean $100 million cherries -- I'm looking at risk going steadily up, and return heading south. Which has GOT to raise a question about how long high rates of LEC investment can continue.

I know the job of a political conciliator isn't easy. I realize you can't rush the education of a great nation.

If there were only some signal that more public policymakers understood that people don't beat their brains and take mighty risks for nothing -- if I could see some sign they understood that, I think I could wait patiently for the mechanics to emerge.

But I see no such sign at all. If you doubt that, just examine the recent PCS Pioneer Preference fiasco.

A PCS license could have quite a bit of value. So the government wants to auction them off.

I have no big problem with that. It will raise our costs, but if everybody's in the same boat, it's a wash. If we can help advance a public goal without messing up the competitive dynamic, fine.

Then the FCC said: "We may give away some licenses to companies that have done distinguished technical R&D in the field of PCS.

But as things turned out, they gave away one of the best licenses in the lot -- a 30-megahertz license. That means only one 30-Megahertz MTA remains, and that creates a scarcity factor in the bidding process.

So -- wait a minute. This Pioneer Preference thing then starts to really mess with competitive balance.

And who wins the Pioneer Preference awards? The Washington Post. Cox Cable -- of the Cox Newspaper chain, and Omnipoint -- the only legitimate pioneer among the three.

And incidentally, there's no way their technical contributions merit a billion-dollar discount.

Well -- when all this was pointed out, fair-minded people agreed. The FCC rescinded the whole scheme and demanded that the former winners pay 90 pct of market value -- still a sizable and unearned break, but better than free.

Now -- the really depressing part.

Here's what happened --

A couple of weeks ago, the formula by which their license fee would be calculated was changed. It had been proposed by the FCC and publicly debated, but now it was changed substantially and appended to the GATT trade agreement.

And as you probably know, members of congress can only vote up or down on trade treaties. The are no amendments.

This has competitively harmed PCS bidders in three large markets.

Our claim is not sour grapes, it's an appeal to simple fairness.

Well, I've talked about a very broad range of public policy issues, federal and state.

We didn't move as far forward as we'd hoped this year, but we weren't pushed backward either.

There is something significant on the plus side. For the first time in memory, telecommunications law was in the headlines and being debated, not just in Washington but in the papers back home.

We educated a lot of people this year. We've identified some hobbling disincentives and some outright contradictions that must be fixed if we are to progress toward an Information Age for America in the 21st century.

We've also learned some things ourselves -- about the players and the process. We've found where the battle lines are drawn -- between the philosophy that says we trust each other and market signals, and the philosophy of those who say we distrust everybody.

Those lessons will put us ahead of where we went in last year.

Meaning, of course, that we WILL be back next Congress. The process we face is, yes, messy. But that won't keep us from once again stating what we believe in, and, if humanly possible, doing it better.

Make no mistake about it. Let our opponents know that we are united on fundamentals, and that we'll fight hard, but fair.

Next year we won't wait till it's over to point out their misrepresentations. In a statesmanlike way, we'll challenge their unsupportable claims from the start.

Any good solution must resolve the universal service obligation, and how we all share it.

It must embrace pure prices caps, MFJ relief, and entry into the cable market on the same day cable is allowed into the telephone business.

Unlike our antagonists, we don't seek something for nothing. We go to Washington prepared to deal.

We can give on presubscription, number portability, and a reasonable form of unbundling -- given we receive reasonable quid-pro-quos.

What we can't do, and what we won't do, is hand over the keys to the store.

The time has come for a solution that looks to America's future, not to narrow interests -- not ours, not theirs, but the country's.

We can live with that, and that's another competitive strength we bring to the battle. For a hundred years, our industry has found ways to accommodate itself to the nation's needs.

We've grown strong that way -- letting the community goals of our society fashion our program.

We take that offer to Washington again in January.

There's a great deal at stake for local exchange companies and for our customers.

Only by sticking together can we hope to prevail. This is a time for unity. Let that be the resolution we all take home.